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To: **Alabama PACT College Saving Plan Board**

From: **Annoesjka West**

Date: **March 12, 2009**

Subject: **Impact of the Current Financial Crisis**

The United States, together with the rest of the world, is in the midst of an unprecedented financial crisis. The bursting of the largest housing bubble in history has resulted in massive de-leveraging by institutions, corporations and individuals. This de-leveraging process has spurred widespread selling of both financial and real assets, causing a rapid decline in asset values and wealth destruction all around the world. The year 2008 was one of the worst and most volatile years for equity markets on record. Bond markets, which historically have been a source of positive returns when stocks go down, also experienced enormous volatility, with great dispersion of results across sectors. Treasury bonds generated double-digit returns, while corporate bonds lost money. The majority of active bond managers were tilted away from Treasuries and suffered losses during 2008, despite a 5.24% gain in the Barclays Aggregate bond index. During this period, there were few ways for a diversified investor to make money. News paper and television coverage have brought the financial crisis to the forefront as investors react to the downturn. The Federal Reserve has pulled out all the stops to combat the financial crisis and to get the economy back on track. The Fed has cut the Federal Funds interest rate to practically zero, has provided an enormous amount of liquidity to the financial system, and has worked with Treasury to bail out several large financial institutions and to inject capital directly into the banking system. The Congress and both the Bush and Obama Administrations have been working on a couple of different stimulus packages. However, monetary and fiscal policies take time to take effect and the markets have been impatient. Individual and institutional investors alike have grown anxious as they have watched their assets decline in value quickly.

The past calendar year was by far the most difficult year for the PACT plan as it, like other institutional plans in the U.S., saw its assets decline significantly. The program lost 31% of its market value in 2008. The bulk of the losses were experienced in a rather short time - September through November - as markets across the world tumbled rapidly after the failure of Lehman Brothers. The extreme market conditions spared no one and other public plans suffered significant losses as well. Some plans fared better than others depending on asset allocation and manager performance, but public plans in the top quartile still

experienced 20+ percent losses. Most pension funds, and state prepaid plans, are now facing similar issues as the Prepaid Affordable College Tuition Plan, going from being close to or fully funded to an underfunded – in some cases, significant - status.

As the investment consultant to the Prepaid Affordable College Tuition Plan, Callan Associates assists the Board with making asset allocation decisions, investment manager selection, performance monitoring and setting investment guidelines. We have worked with the program for over five years and during this time we have conducted two asset allocation and liability studies and several manager searches. Our most recent asset allocation and liability study was completed in February 2008. The goal of the asset allocation and liability study is to establish an appropriate long-term strategic asset mix, given the plan's long-term actuarial discount rate, the funded status of the plan, the value of the future tuition benefits promised to participants, and the costs of the contracts. We use the program's actuarial report to provide the necessary information to build our model. The study is conducted in three phases, briefly described as follows:

- 1) Establish Capital Market Assumptions: during this phase we establish five-year risk and return assumptions for the major asset classes.
- 2) Range of Allocation Configurations: during this phase we examine a range of efficient asset allocations, from conservative (lower equity exposure) to aggressive (higher equity exposure) with each allocation configuration providing the lowest level of risk given for a given level of return.
- 3) Simulation: during this phase of the process we use a simulation model to project the program's assets and compare those with future expected liabilities under a large number of economic scenarios for several future time periods. The objective is to identify the optimum allocation to meet the Pact Trust Fund's goals.

The result of our asset and liability studies indicated that the PACT program needed to maintain an equity allocation greater than that to fixed income, given the higher actuarial discount rate and the high level of expected tuition inflation. Over the long-term equity returns tend to be higher than fixed-income returns, but equity investments are also more volatile than fixed income securities. Therefore, a higher equity allocation usually results in a higher expected rate of return, but with more volatility (or risk). Our first asset allocation and liability study resulted in a recommendation to increase the allocation to international equity at the expense of domestic equity. The second asset allocation and liability study resulted in a recommendation to add real estate to the portfolio to further diversify the asset base. This change has not yet been implemented and has been put on hold for the foreseeable future. Since our involvement and prior to that, the PACT has maintained a diversified mix of bonds, domestic stocks and international stocks in its portfolio, with roughly one third of the assets allocated to bonds. This asset allocation strategy was put in place to balance the need for return with prudence and risk management.

The plan uses nine professional investment advisors to manage the different slices of the portfolio. Over the years, Callan has assisted the Board with several manager searches. The goal of our due diligence process is to provide the Board with the information and insight needed to make the most appropriate manager selection with comfort and confidence. We maintain a large database of institutional quality managers. It is important to note that managers do not pay Callan a fee for participation in the database or for being considered or hired by our clients. Each time we conduct a search for the PACT, we screen our database to find those candidates that meet the requirements of the program. We also use a peer review committee to review all the candidates that are presented to a client. The PACT board receives a due diligence report for all the semi-finalist candidate firms and then conducts interviews with each of the finalists. Callan has always presented reputable, institutional-quality investment manager candidates to the PACT Board with a documented track record of success. Although a manager's long-term track record is considered in the process it is not the main driver for selection. As with all investments, past performance is not a guarantee for future success. Over the years, there have been managers who have not been able to meet their performance target and some have been terminated as a result.

Finally, many participants have asked why the program did not move out of equities as the markets tumbled. There are several important reasons why Callan does not make tactical, short-term recommendations to our clients. First, Callan's role is that of a long-term, strategic advisor. We have never made any tactical or "market-timing" calls with respect to asset allocations for our clients. Second, large asset allocation moves are expensive and risky. An investor needs to make the call "right" twice: when to get out of the market and when to get back in. We don't believe that we are equipped to make that call and are not aware of any investor who has been able to do so consistently. Third, the PACT, like all our other clients, has set strategic targets with rebalancing ranges in their investment policy statement. These policies are meant to impose an investing discipline that has been set over time and to discourage rash decision making based on short-term market fluctuations. Finally, we understand that our clients, their beneficiaries and participants and all of our investment colleagues are disappointed, frustrated and faced with financial difficulties as a result of the market's unprecedented fall. Unfortunately, we all wish we had had the foresight to know what was coming. The reality is that no one did. It is a small conciliation to know that most market prognosticators believe that much opportunity lies ahead. While that may be the case, we can't say with any certainty when the markets will turn. We continue to believe that staying the course, though difficult, is the best course of action. It is our observation that successful management is based on the discipline of sticking to the long-term asset allocation strategies designed for the plan's financial needs. In today's environment, the ability to stick with this discipline is complicated by short-term budgeting and operational needs. Acknowledging and managing the short-term needs while keeping an eye on the long-term, we believe, continues to be the best approach.